25 June 1985

MEMORANDUM FOR: Roger B. Porter
Executive Secretary
Economic Policy Council

FROM: David B. Low
National Intelligence Officer for Economics

SUBJECT: "Junk Bond" Legislation; your Memorandum of June 20, 1985

On behalf of Director Casey as a member of the Cabinet, this is to confirm that he supports the Administration's approach of opposing the referenced bills introduced in the Congress which would restrict the use of such securities.

David B. Low

(never sent)

ROUTING AND TRANSMITTAL SLIP Date 6/24

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REMARKS

Even though this is a domestic issue, should we not send a note pointing that out but getting usun voting record?

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Remarks

For direct response BY COB 25 Jun, Please.

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Executive Secretary

24 Jun 85

Date

3637 (10-81)

THE WHITE HOUSE

WASHINGTON

20 June 85

June 20, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER RBP

SUBJECT: "Junk Bond" Legislation and Depository Institutions

On Monday, June 17, a paper on "'Junk Bond' Legislation and Depository Institutions" was circulated to Council members. The paper concerns several bills that would restrict the use of high-yield securities in takeover attempts that have been introduced in the Congress in recent weeks. These bills are of three basic types:

1. Imposing a moratorium on the use of high-yield securities to finance most hostile takeovers.

2. Disallowing a deduction from taxable income of interest paid with respect to debt incurred during a hostile takeover regardless of whether the debt is in the form of a bank loan or of debt securities and regardless of whether it is high-yield or investment grade.

3. Imposing either a permanent ban or statutory limitation on high-yield security purchases by federally-insured depository institutions.

These proposals raise two basic issues:

1. Is the use of high-yield securities in corporate takeovers, which has the effect of increasing corporate debt-equity ratios, potentially harmful to the economy so as to require a Federal legislative response?

2. Does the purchase of such securities by institutions whose obligations are insured by the Federal Government undermine the safety and soundness of the financial system or expose the Federal Government to undue risk of financial loss?

The paper distributed on Monday included an analysis of these issues. From that analysis, it appears that these bills would serve principally to inhibit hostile takeover threats to large corporations. Insofar as they would have this effect, all three types are inconsistent with the position on corporate takeover legislation approved by the President.

Some of these bills may move soon in the Congress and the Administration will need to respond rapidly. Secretary Baker has requested that I poll council members to ascertain if they have any objection to the Administration opposing these bills.

If you do not approve of the Administration opposing these bills, please notify me by close of business on Tuesday, June 25, 1985.

A copy of the memorandum circulated last Monday is attached along with a copy of the Administration Position on Corporate Takeovers approved by the President last March.

Attachments

cc: Donald T. Regan
Alfred H. Kingon

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

JUN 17 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: DOUGLAS H. GINSBURG DHG
Administrator for Information and Regulatory Affairs

SUBJECT: "Junk Bond" Legislation and Depository Institutions

Several bills have been introduced in this Congress that would restrict the use of high-yield securities.[1] One form of restriction would impose a moratorium on the use of "junk bonds" to finance most hostile takeovers.[2] A second form would disallow a deduction from taxable income of interest paid with respect to debt incurred during a hostile takeover regardless of whether the debt is in the form of a bank loan or of debt securities, whether "junk" or of investment grade.[3] A third form would impose either a permanent ban or statutory limitations on "junk bond" purchases by federally-insured depository institutions.[4]

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[1] High-yield securities (also known as "junk bonds") are generally defined as publicly traded debt instruments that are either unrated or rated below the top four ratings by Moody's Investors Service or Standard and Poors Corporation.

[2] S.975 (Domenici), H.R. 2400 (Richardson)

[3] S. 420 (Boren), S. 476 (Boren), S. 632 (Chaffee), H.R. 1003 (Jones), H.R. 1100 (Jones), H.R. 1553 (Dorgan), H.R. 2476 (Pickle). H.R. 1553 and H.R. 2476 would apply to friendly as well as hostile takeovers of large corporations only. Treasury's Assistant Secretary Pearlman has testified in general opposition to the tax bills before both the Senate Finance Committee and the House Ways and Means Committee (see Attachment A).

[4] S. 975 (Domenici), S. 1286 (Domenici), S. 1016 (Proxmire), H.R. 2400 (Richardson), H.R. 2476 (Pickle).

These proposals all raise two basic issues:

- o Is the use of high-yield securities in corporate takeovers, which has the effect of increasing corporate debt/equity ratios, potentially harmful to the economy so as to require a Federal legislative response?

- o Does the purchase of such securities by institutions whose obligations are insured by the Federal Government undermine the safety and soundness of the financial system or expose the Federal Government to undue risk of financial loss?

Our review of the relevant evidence leads us to conclude that the answers are negative. The bills described above would serve principally to inhibit hostile takeover threats to large corporations. Insofar as they would have this effect, they are inconsistent with the President's position on corporate takeover legislation (see Attachment B). They would also deprive depository institutions of legitimate investment opportunities that may be preferable to alternative opportunities. The analysis that follows addresses the two basic issues identified above.

THE "LEVERAGING OF CORPORATE AMERICA" IS NOT DRIVEN BY JUNK BOND FINANCED HOSTILE TAKEOVERS

As an initial matter, it is useful to note that corporate debt-equity ratios are not out of line with recent economic experience, and that much of the talk about dangerous leveraging of the corporate sector has little foundation in fact. Moreover, to the extent that debt-equity ratios have risen, high-yield debt securities are not responsible for most of that increase.

According to data gathered by the Federal Reserve Board, aggregate corporate debt-capitalization ratios, measured on a market-value basis, stood at 42.2% by year-end 1984 (see Table 1, attached). Currently, the Federal Reserve estimates that, because of the recent increase in stock market values, aggregate debt-capitalization ratios stand at about 42.0%. Although the year-end 1984 figure represents an increase of 4.2 percentage points over 1983, recent ratios are in line with the experience of the 1970's and the most current ratio is lower than debt-capitalization ratios experienced in five of the last ten years.

Issuance of high-yield securities has increased greatly in recent years. Of the $59 billion in public straight debt high-yield bonds outstanding, about 40% have been issued during the last two years (1983--$8.5 billion; 1984--$15.8 billion). Such securities account for an increasing share of both new corporate bonds and new corporate borrowing (25% and 10%, respectively, in 1984).

Nevertheless, all high-yield securities still make up only a small part (4.5%) of corporate debt outstanding; those that are related to hostile takeovers make up a much smaller part.

Critics of junk bond financed hostile takeovers cite a net decline in corporate stock issuance of $90 billion in 1984 as evidence that such takeovers are doing serious damage to the economy. Since all of the high-yield securities issued in 1984 could account at most for only 17.5% of that decline, it is clear that the principal sources of the increasing leverage are not junk bonds, but rather bank and finance company loans, commercial paper, and other bond issuances. These sources are fungible with junk bonds and can be issued for all the same purposes--corporate growth, leveraged buyouts (going private transactions), financial restructuring, and takeovers (hostile or friendly).

Although it is likely that the threat of a junk bond financed takeover has stimulated some mergers or leveraged buyouts, as well as the financial restructuring of some companies, it is impossible to assess the magnitude of their influence in these areas or to conclude whether they represented sound business judgment. What can be said is that these transactions were entered into by sophisticated investors risking either their own money or money for which they are responsible. They have every incentive to structure their deals so as to make them work, and not to enter into over-leveraged investments.

FEDERAL EXPOSURE TO "JUNK BOND" RISK IS NOT SIGNIFICANT

Federally-insured institutions are not heavily invested in high-yield securities. Bank regulators indicate that they believe bank holdings of high-yield securities are not significant, although none of the regulators currently collects data on a regular basis that address the question directly. The FHLBB staff, based on a recently completed survey, estimates that S&Ls hold about $5 billion of such securities (about one-half of one percent of total S&L assets of $1 trillion), concentrated mostly in ten large State-chartered S&Ls. Although pension funds also hold over $1 trillion in assets, a recent survey of over 100 pension fund managers found that only 3.3% invest any of their assets in high-yield securities.

A reasonably diversified portfolio of "junk bonds" appears to be a good investment. High-yield securities generally yield between 300 to 500 basis points above comparable maturity U.S. Treasury obligations. Although the default risk on these securities is greater than for investment grade securities, all studies of which we are aware have concluded that the high-yield interest rate premiums have historically been more than adequate to offset the additional risk of default. These studies covered varying periods from 1900 to 1984, but focused mostly on the last ten years. There may be somewhat greater risk in the bonds

issued recently for leveraged buyouts and takeovers. It is much too soon, however, separately to evaluate the additional risk, if any, that takeover-related loans may pose.

Morgan Stanley estimates that the default rate on straight high-yield securities was 1.6% (160 basis points) annually from 1974 to 1984. Actual losses resulting from default were significantly lower because defaulted bonds do not become valueless. Morgan Stanley found that defaulted bonds trade at an average of 41% of par shortly after default. The value-adjusted default rate is thus about 1.06% per year, substantially below the 490-580 basis point premium to government bonds that Morgan calculates was available over the same period.

Notwithstanding this rosy historical outlook, the nature of the high-yield debt outstanding may be changing significantly with the dramatic growth in volume between 1977 and today.[5] The degree of leveraging in recent takeovers, leveraged buyouts, and restructurings is probably greater than that faced by the operating company issuers of the past. Thus, it may be inappropriate to extrapolate without qualification from this historical record and to conclude that takeover-related junk bonds will match the default experiences of past issuances.

It would also be inappropriate, however, to conclude that takeover-related junk bonds will not have a similarly positive record. These bonds are sold in competition with other high-yield instruments, and if they did not offer an adequate return, they would not be purchased by the highly sophisticated investors who buy most "junk bonds." Because of the dominance of these sophisticated investors, they, not the smaller investors such as S&Ls, set the terms of these public securities. Moreover the equity investors have every incentive to make the deal successful, since they would lose their investment first in a failure.

Finally, the risk presented by high debt-equity ratios is often relatively short-lived. Target companies often restructure themselves by selling off assets and paying down their debt, or undertaking refinancings that result in a lower debt burden.

<u>Current Federal law provides adequate authority to protect the Federal Government</u>. The general rule for investment in corporate debt securities by federally-chartered depository institutions and State banks that are members of the Federal Reserve System is that they may not invest in securities that are rated below "investment grade." Therefore, they are not allowed to hold low-rated (junk) bonds as investment securities. They are

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[5]Morgan Stanley estimates that low-rated straight public debt outstanding has grown from $8.5 billion in 1977 to $41.7 billion at the end of 1984. New issues during the same period have grown from $1 billion to $15.8 billion annually.

allowed to own unrated (junk) bonds (subject to a prudent judgment rule) and obligations that may be transferred to their commercial loan portfolio, but they rarely do so. National banks and federally-chartered thrifts may not invest more than 10% and 15%, respectively, of their capital plus surplus in a single issue. In addition, federally-chartered thrifts are subject to a limitation on aggregate commercial loans of 10% of assets.

Likewise, State-chartered nonmember banks generally must limit investments to securities that are either investment grade or, if unrated, are "prudent." They are also subject to FDIC examination standards that may, on a case-by-case basis, revalue unrated securities or those below investment grade at market value. State-chartered thrifts are subject to State law, which generally parallels Federal law in this area except that some major States (e.g., California) have different limits on the percentage of commercial loans a thrift may hold in its portfolio. State-chartered thrifts are also subject to the same single issuer limits as Federal thrifts--15% of capital plus surplus. The FHLBB is presently considering additional rules to limit thrift investments in high-yield securities.

Both bank and thrift regulators already have the statutory authority to restrict or prohibit any unsafe or unsound practice that is likely to cause substantial dissipation of the assets or earnings of an institution, or seriously to weaken its condition. In addition, both the Vice President's Task Group on Financial Services Regulation and the CCEA have recommended that legislation be developed to enable the regulators to vary deposit insurance premiums based on objective or market-based determinants of risk.

One other source of potential Federal exposure is through pension funds guaranteed under ERISA. Pension funds are limited in their investments by a "prudent investor" standard that, given the results of the myriad studies of risk and return, should require only a reasonable amount of diversification and due diligence in order to enable them to invest significantly in high-yield securities. The employer, however, stands between the pension fund and the Federal Government; the Pension Benefit Guaranty Corporation (PBGC) would be exposed to loss only if an employer were unable to meet any unfunded liability arising from a default.

A PROHIBITION WOULD LIKELY DO MORE HARM THAN GOOD

A prohibition on federally insured depository institutions' purchase of junk bonds is unlikely to have any beneficial effect on depository institutions. Although it would stop depository institutions from investing in "junk bonds," it would not stop them from extending the same credit in the form of a commercial loan. Indeed, the commercial loan may be <u>more</u> risky since it is

not likely to be readily marketable and is not subject to the more extensive market judgement that publicly traded securities undergo.

We have not seen any evidence to indicate either that depository institutions in general are heavily invested in these instruments, or that the investments are unduly risky. Moreover, the Federal regulators already have the authority to deal with individual problems should they arise. A prohibition will not improve the safety and soundness of depository institutions; it will merely cause the market for high-yield securities to be a little smaller--by about 5-10%. Furthermore, it would remove from the institutions a legitimate investment option that may be less risky than other available options.

TABLE 1

DEBT-TO-CAPITAL RATIOS
NONFINANCIAL CORPORATIONS

Year	Debt (Par)[1] / Equity (Current)	Debt (Par)[2] / Equity (Market)	Debt (Market)[3] / Equity (Market)
	---percent---		
1961	29.12	27.82	26.09
1962	29.81	31.32	29.78
1963	30.81	29.43	28.01
1964	31.21	28.49	27.38
1965	31.73	28.58	27.38
1966	32.17	32.62	30.26
1967	32.76	29.25	26.69
1968	33.55	28.69	26.25
1969	33.44	33.47	29.33
1970	33.66	35.35	32.43
1971	33.63	33.33	31.83
1972	33.45	32.46	31.22
1973	32.86	40.38	38.23
1974	30,48	51.27	47.67
1975	29.36	44.28	41.86
1976	29.12	42.59	42.16
1977	29.27	46.68	45.65
1978	29.14	48.66	46.67
1979	28.52	47.01	44.13
1980	27.45	41.17	37.58
1981	27.72	45.27	41.18
1982	28.58	43.71	41.55
1983	28.88	40.89	38.76
1984	32.20	44.38	42.23

1. Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.

2. Debt is valued at par, and equity is market value of outstanding shares.

3. The market value of debt is a staff estimae based on par value and ratios of market to par value of NYSE bonds; equity is market value of outstanding shares.

Source: Based on Board of Governors of the Federal Reserve System, Flow of Funds.

May 1, 1985; Revised per May 15 memo.

THE WHITE HOUSE

WASHINGTON

March 8, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Corporate Takeovers

There has recently been much attention focused on corporate takeovers and the need for any Federal legislation restricting such activities. A House subcommittee is currently holding hearings on takeovers and has asked the Administration to testify on March 12. This memorandum presents the Cabinet Council's findings on the value of takeovers and recommendations for an Administration position on possible Federal legislation.

Background

Mergers and acquisitions occur because of, among other factors, the belief that the combined company can operate more efficiently than two companies operating separately. In friendly mergers and acquisitions, which account for the overwhelming majority of such transactions, both parties agree on these benefits. In hostile takeovers, managers of the target company (the company being acquired) oppose the transaction because they: (a) fear the loss of their jobs; and/or (b) believe their shareholders would be better off if the company remained independent or merged with a different company.

In a hostile takeover, a bidder typically buys a significant percentage of the target company's stock and offers to pay other shareholders a premium for their shares. The bidder seeks to obtain enough shares, usually 51 percent, to gain control of the target company. The target management seeks to prevent the bidder from gaining control, typically through defensive tactics such as litigating against the bidder or buying the shares already owned by the bidder.

Last year, the Senate passed amendments to the banking bill restricting certain takeover activity, while the House considered, but did not pass, separate legislation. The Securities and Exchange Commission (SEC) proposed restrictive legislation last year, but recently indicated it will oppose such legislation this year. While there will be pressure from some segments of the business community for restricting bidder tactics and from stockholder groups for restricting defensive tactics, the likelihood in this session of Federal legislation restricting takeovers appears to be limited.

Principal Findings

The Cabinet Council on Economic Affairs has conducted a detailed study which examined two central issues: (1) the economic impact of takeovers and the extent of abuses; and (2) the appropriate Federal role, if any, in correcting these abuses. Based on this study, the Cabinet Council has approved recommending to you a statement of the Administration's position on corporate takeovers to guide Administration testimony on this issue. A copy of the proposed statement is attached. The principal findings of the Cabinet Council study are:

1. Corporate takeovers generally benefit the economy by enabling companies to achieve efficiencies, shift assets to higher valued uses, and police management conduct.

2. To the extent there are abuses in the takeover process, it appears shareholders need protection from the management of the target company, rather than from the bidding company. Because managers may primarily be interested in keeping their jobs, they may oppose a takeover bid that is in the best interests of the shareholders of the target company.

3. There is great capacity through the market, the States, and the courts to correct these abuses. There is no compelling evidence that these checks are inadequate. The market can react through changes in corporate charters. Institutional investors are starting to oppose target managements that resist takeovers. The States can pass laws governing abusive defensive tactics. The courts are able to distinguish between abusive and legitimate uses of defensive tactics by considering the unique facts of a particular case.

4. Only if there is a serious market failure of national dimensions should the Federal Government then consider taking appropriate steps to curb the potential for abuse. This position is shared by the chairman of the SEC.

The Council also considered the three major arguments made by critics of takeovers:

- Takeovers reduce competition. By reducing the number of competitors in an industry, takeovers increase the likelihood of higher prices than what a more competitive market would have produced.

However, the Department of Justice and Federal Trade Commission actively oppose mergers and acquisitions, whether friendly or hostile, that threaten to reduce competition.

- o Takeovers financed by borrowing divert capital from more productive uses. When a bidder borrows bank funds for a takeover, it ties up money the bank could have lent to companies making "real" investments, instead of simply pursuing "paper profits."

Takeovers result in real benefits of greater efficiency, and not simply the pursuit of paper profits. Moreover, when a bidder buys shares in the target company, the funds are not diverted. The shareholders selling their shares to the bidder in turn invest these funds in the economy.

- o Hostile takeovers force managers to focus on short-term protection against takeovers, rather than on long-term investments.

This argument overlooks the point that the best means of avoiding hostile takeover attempts is to maximize shareholder wealth, which reflects the long-term competitive prospects of the company. If the stock market does not think a company is making good long-term investments, the price of the company's share will fall, making it more vulnerable to takeovers.

Recommendation

The Cabinet Council on Economic Affairs unanimously recommends that you approve the attached Administration position on corporate takeovers.

Approve Ronald Reagan Disapprove ________

James A. Baker III

James A. Baker III
Chairman Pro Tempore

Attachment

PROPOSED ADMINISTRATION POSITION
CORPORATE TAKEOVERS

I. Corporate takeovers perform several beneficial functions and are generally good for the economy.

II. The Williams Act represents a compromise between the desire to afford target shareholders and managements adequate disclosure and a reasonable period of time in which to evaluate offers, and the needs of the competitive markets in securities and in corporate control to operate with a minimum of government regulatory interference. We have not seen sufficient evidence that the existing provisions of the Williams Act are inadequate to achieve their purpose.

III. Various limitations on bidder activities have been proposed, but a need for additional restrictions on bidders has not been demonstrated.

IV. Target company shareholders need and have protection from abuses by target managements in conjunction with contests for corporate control.

V. State law, enforceable in the courts, governs the permissible terms of corporate charters, management contracts, and managers' and directors' fiduciary obligations, each of which may serve to check management abuses. From existing state statutes and decisions of state and Federal courts, however, it is unclear whether state law is adequate to portect target company shareholders from abuses by target management. As new defensive tactics evolve, moreover, existing protections may prove inadequate.

VI. The balance between management's need to act expeditiously in the interest of the corporation and the shareholder's right to call that action into account should be resolved at the level closest to the problem and the relevant facts--by the corporation, its owners, and managers in the first instance; by state law, if necessary; and, by Federal law only as a last resort. If there is a serious market failure of national dimensions, then the Federal Government should consider taking appropriate steps to curb the potential for abuse. Otherwise, the Federal Government should take no step towards the establishment of Federal corporation law to govern relationships between shareholders and managers.

VII. While matters of corporation law have traditionally been the subject of state rather than Federal jurisdiction, the Federal Government should play an informational role by making public the best information about critical issues that shareholders are likely to face in many corporate change of control contests.

VIII. The Federal Government should also carefully consider the unintended effects that other Federal policy decisions may have on merger and acquisition activity. To the extent that these Federal decisions encourage more or less merger and acquisition activity than otherwise would have taken place in a free market, resources may be misallocated.